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GRAY
Drug Stores, Inc.

Annual Report-Year Ended April 30, 1975

What We Do...and Where!

Gray Drug Stores, Inc., founded in 1928, operates one of the nation's principal drug chains and a major discount department store chain, both of which aggressively emphasize discount pricing plus good service, wide product selection and attractive store decor. Our Drug Division includes 170 drug stores, 17 leased departments in the stores of other retailers, and leased departments in our Rink's Department Stores. Our Discount Department Store Division includes 39 stores, all under the Rink's name and generally 80,000 to 100,000 square feet in size. We believe in a regional rather than geographically dispersed concept of operation, to assure close management control and maximum efficiency. Most of our drug stores and all of our Rink's stores are in Ohio and adjacent areas. We are developing a major new regional base of drug store operations in Florida, where we now have 39 stores. We also operate a large photo developing plant in Cleveland under the name of Superior Laboratories.

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The Year in Summary

Operations

Fiscal Years Ended April 30	1975	1974	Increase (Decrease)
Net Sales	$272,063,514	$253,173,340	7.5%
Income Before Income Taxes	7,506,811	6,336,144	18.5%
Net Income	3,923,811	3,409,144	15.1%
Net Income Per Share	2.36	2.05	15.1%
Dividends Per Share	.425	.60	(29.2%)
Working Capital	37,003,354	32,406,610	14.2%
Shareholders' Equity	38,458,532	35,242,371	9.1%

Stores and Leased Departments

	April 30				
	1975	1974	1973	1972	1971
Drug Stores	170	167	167	165	167
Leased Drug Departments in Stores of Other Retailers	17	25	27	30	28
Discount Department Stores	39	39	34	30	27
Total Outlets Excluding Intra-Company Leased Departments	226	231	228	225	222

Common Stock Prices and Dividend Information

Gray Common Stock, par value $1.00 per share, is traded on the New York Stock Exchange and the Midwest Stock Exchange. Our market symbol is GRY. The market range and dividends paid, by quarter, for fiscal years 1975 and 1974 are indicated below.

	Sales Price Per Share				Dividends Per Share	
	1975		1974			
QUARTER	HIGH	LOW	HIGH	LOW	1975	1974
First	8½	6¼	17¾	10½	$.10	$.30
Second	7¾	5½	11⅞	8⅜	.10	.10
Third	8¾	5	9⅜	5⅞	.10	.10
Fourth	11½	8¼	9½	6⅞	.125	.10

To Our Shareholders

Gray Drug Stores, Inc., increased profits by 15 per cent during the past year in spite of the twin national problems of inflation and recession.

Net income was $3,923,811 or $2.36 a share for the fiscal year ended April 30, 1975, compared with $3,409,144 or $2.05 a share earned in the preceding year.

Sales, increasing for the 26th consecutive year, totaled $272,063,514 compared with $253,173,340 a year ago.

In the fiscal fourth quarter, a depressed period for retailing generally, the Company earned $1,073,151 or 65 cents a share, an increase of four per cent over the $1,027,164 or 62 cents a share earned in the same three months of the prior year. Sales were $61,889,209 compared with the year-ago $59,800,038.

The Drug Division contributed $3,200,345 to fiscal 1975 profit, compared with $1,758,814 in the preceding year. Sales of the division were $144,814,071 compared with $133,905,781. The Discount Department Store Division earned $723,466 compared with $1,650,330 in the preceding year. Sales were $127,249,443 compared with $119,267,559.

Long-range Programs

Major programs to open the way for large-scale growth on a profitable basis were instituted several years ago to strengthen our long-established position as one of the nation's principal drug chains and to make our Rink's Department Stores chain a dominant retailing factor in the comparatively limited regional area it serves.

These programs included a sharp reduction in drug store pricing to stimulate necessary volume, improvement in the location and quality of our drug stores within our existing service area, acquisition and expansion of a Florida drug store chain, construction of large and efficient distribution centers controlled by advanced computer systems and serviced by our own truck fleet, and opening of 16 large new discount department stores in four years.

The cost of these projects was substantial, in terms of immediate profits and long-term capital commitments, but this investment in the future was vital to the development of future profit opportunities.

Gray Drug constantly strives to be a corporate good citizen in the areas it serves. We received the prestigious Gold Link Award of the National Association of Chain Drug Stores as a result of our distribution of free prescriptions, clothing and blankets to victims of a tornado which devastated Xenia, Ohio, in 1974. Gray Drug and its employees also have just received an "Extraordinary Support" award from United Torch Services as a result of increased contributions last year.

The results were dramatically apparent in the Drug Division during the past year. Drug store operation is normally a stable business, with steady rather than spectacular profit increases on an annual basis. However, in fiscal 1975, Drug Division profits increased 82 per cent from the reasonably strong performance of the prior year.

This profit improvement is a result of increased gross margins, the continuing rising volume resulting from the division's change to and emphasis on discount pricing, better performance by Florida stores, inflation, and from other phases of long-range programs to improve our efficiency and profit.

While net income of the Discount Department Store Division was down due to bad weather during key selling seasons and the generally dismal consumer buying patterns prevalent in its industry during the last half of the fiscal year, it did earn a profit at a time when large losses were incurred by many other discount department store operations. Even more important, it made progress in efficiency and expense control programs, and in positioning itself for significant profit improvement if consumer confidence returns as expected.

Balance-Sheet Strengthened

An intensive effort was made during the year to strengthen our balance sheet. Financial controls were tightened and many projects to improve efficiency were given prime management attention.

The results can be measured not only in profit but in a $6,300,000 reduction in total borrowings and a far stronger and more liquid financial position than prevailed a year ago.

Dividends of 42½ cents per share were paid during the fiscal year, including 10 cents in each of the first

three quarters and an increase to 12½ cents in the final quarter. Gray Drug has paid a cash dividend every year since 1929, our first year in business.

Internal Growth Emphasized

The past year's sales gain was achieved with an actual decrease in the number of stores operated. The Drug Division opened nine new outlets while closing 14 marginal ones, including leased drug departments; there was no change in the number of department stores, with a large new one opened and a smaller one closed. However, we carried out a very active and successful store remodeling program which is having a favorable impact on sales and profit.

We plan to continue this general policy of emphasizing growth in sales per store rather than growth in store numbers during the present fiscal year as a means of conserving capital and concentrating on profit improvement.

Outlook Is Encouraging

Gray Drug, through the hard work and enthusiasm of its employees, who now number 5700, has emerged from a difficult period with growing profits, an improved financial position, and excellent opportunities for continuing progress. With sales nearly doubled since 1969, we occupy a position of leadership in the regional areas we serve.

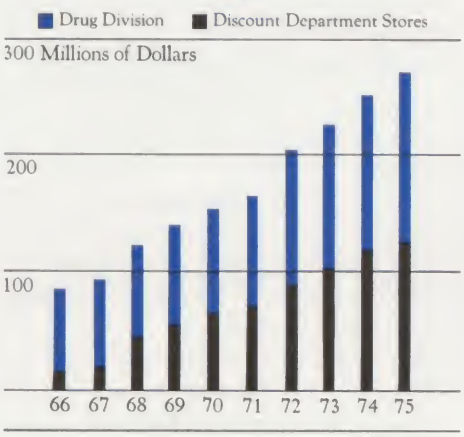
Inflation and the high cost of borrowed capital obviously are serious problems to any company as well as to our nation, and recession and unemployment bite deeply into department store sales. However, the Drug Division's profit momentum is based on solid foundations and should continue to develop. While it is too early to forecast when the long-awaited upturn in consumer confidence will occur or how strong it will be, any improvement should be reflected in profits of our department stores. We believe our outlook for continuing progress during the current year is good.

Sincerely,

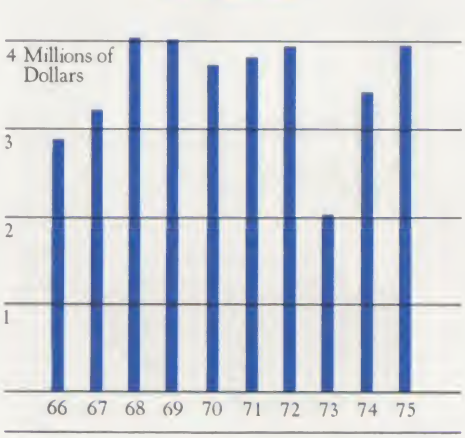
Jerome A. Weinberger
President and Chief Executive

July 29, 1975

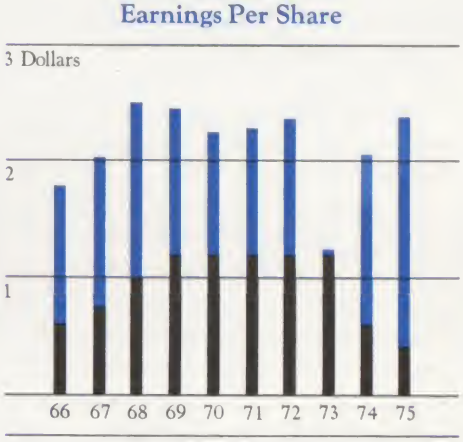
Sales



Net Income



Dividends
Earnings Per Share



"Continued strengthening of our balance sheet is anticipated during the current year."

Financial Information

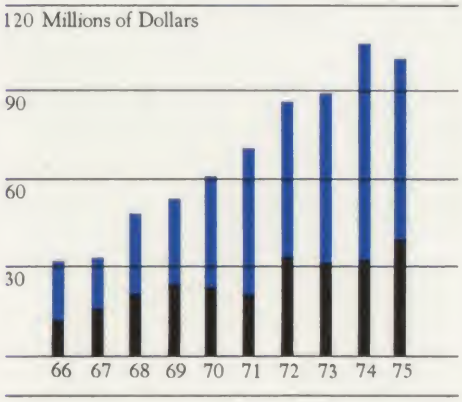
Total borrowings at the fiscal year-end were $29,900,000, down 17.4 per cent from the $36,200,000 of a year ago.

Interest expense during the year was $3,232,242, compared with $2,945,744 in the preceding year, and interest rates averaged 11.4 per cent on short-term bank borrowings, well above present levels. The combination of current lower rates and our reduction of total debt should have a favorable effect on current operations.

Inventories were reduced by $5,648,689 or over seven per cent last year in spite of our increase in sales. Working capital was a record $37,003,354 at the fiscal year-end, and current assets of $80,519,760 were at a ratio of 1.9 to current liabilities of $43,516,406, compared with a ratio of 1.6 a year ago. Shareholder equity was at an all-time high of $38,458,532 or $23.10 a share.

Continued strengthening of our balance sheet is anticipated during the current year.

Working Capital
Assets



Drug Division Profit Programs

The Drug Division's 82 per cent profit increase last year, on an 8.1 per cent increase in sales, results from increased gross margins, continuation of consumer enthusiasm for our aggressively competitive discount pricing and the success of our on-going profit programs as well as inflation.

The division at the fiscal year-end was operating 170 drug stores, 17 leased departments in the stores of other retailers, and 38 leased departments in our own Rink's department stores. New drug stores were opened during the year in Steubenville, Ohio, in two suburbs of Cleveland, in Cincinnati, and in Miami, Port St. Lucie, North Lauderdale and Perrine, Florida. Four Ohio drug stores were closed and one in Florida was sold. A leased department was opened in our new Rink's store at Lima, Ohio, and one was closed with the closing of a small Rink's store in Michigan. Eight leased departments in the stores of another retailer also were closed.

Closing of marginal outlets and opening of stronger ones in better locations is a characteristic of our operations. While the number of Drug Division outlets has remained relatively stable in recent years, the total operation has been considerably strengthened in this manner. Sales of comparable free-standing stores were up more than 13 per cent last year, in spite of a decline in sales by restaurant departments, which were phased out

in a number of stores to make room for more profitable departments.

One of the ways we increase sales per store is through remodeling. This involves a wide variety of work ranging from new store fronts and layouts to new fixtures and elimination of soda fountains. Objectives are to improve sales, to increase gross profit margins by changes in product mix and by creating extra space for more profitable items, to control payroll needs and to strengthen security.

Thirty-four stores were remodeled in fiscal 1975, with the work carried out at various dates. Sales in these stores increased 17½ per cent from the time of remodeling until the end of the year.

These stores, open on a full-year basis, will contribute additional volume growth in fiscal 1976 and remodeling of a record 40 additional stores is planned. While this type of sales and profit improvement activity will be stressed rather than new store openings, we will open five stores during the current fiscal year. One at Port Richey, Florida, has opened and another Florida store will be opened at Homestead. The other new stores will be at Mansfield, Strongsville and Westlake, Ohio.

Another important element of the Drug Division's progress is its rising prescription business. There were 7,128,000 prescriptions filled last year. These accounted for 23 per cent of the division's sales compared with 21½ per cent in the preceding year. This is sharply higher than the national average for all chain drug stores, whose prescription volume amounted to only 16.1 per cent of sales in calendar 1973, the last year for which figures are available.

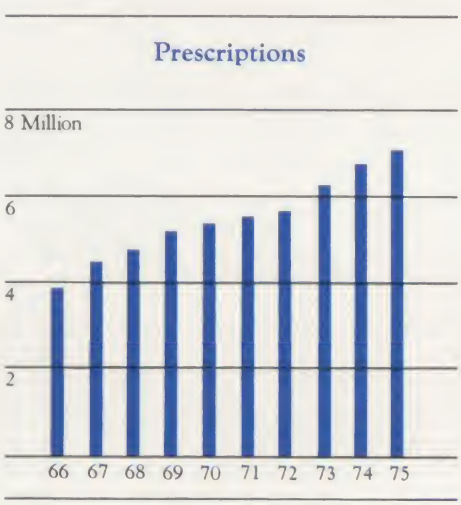
Florida operations were another bright spot, and are vastly different today from the money-losing stores we acquired there at the end of fiscal 1971 to provide a new regional base for drug store development.

Marginal stores have been closed or sold. All of the remaining stores have been remodeled. New stores have steadily been opened, strengthening our operations on the East Coast and expanding them to the state's West Coast and to Central Florida.

The result is a modern group of 39 Florida drug stores in an area of substantial growth potential for Gray Drug. Comparable stores in Florida increased sales by a slightly larger margin than those in Ohio and adjacent states last year, and while profit margins in Florida are still modest, they increased by a large percentage.

The key to progress in drug store

"Thirty-four stores were remodeled... Sales in these stores increased 17½ per cent..."



"Sales of the Drug Division during the first two months of the current year increased at a faster pace than last year's average . . ."

operation or any other phase of retailing is to increase sales more rapidly than expenses. This was the goal of our program under which prices were cut in the face of inflation starting several years ago . . . a big and pioneering goal for a chain offering our type of service. It has worked, and we are confidently and aggressively advertising our lower prices.

Our leased prescription, health and beauty aids and photography departments in discount department stores, including all Rink's stores except one, represent a plus in our operations.

Our Superior Laboratories operation, which is a part of the Drug Division and operates one of the nation's larger photo developing plants, serving our stores and other large customers, is another plus in the division's activities.

Sales of the Drug Division during the first two months of the current year increased at a faster pace than last year's average, and the division has targeted for another year of volume and profit progress.

Rink's Stores in Solid Position

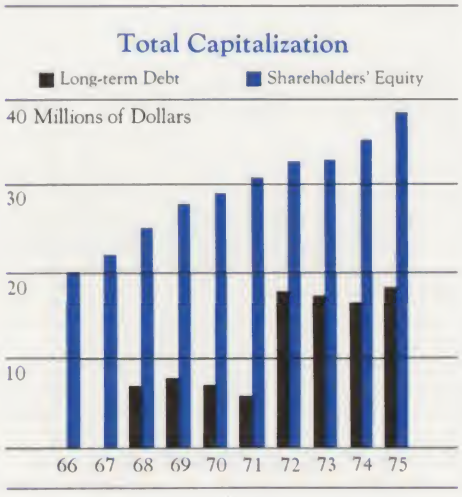
While profits of our Rink's Discount Department Stores were down last year, this division is in a good position for improved performance.

It earned a profit while many large discount department store chains were losing money, closing large numbers of stores, and even going bankrupt, with many of the nation's largest mass retailers suffering severe profit declines.

Rink's not only weathered the economic turbulence, but continued with long-range programs designed for future progress. Inventories were reduced by $7,500,000 in spite of the increase in sales.

The division's profit performance was ahead of the previous year until Thanksgiving. Then one of the worst blizzards in Ohio history cut consumer traffic to near zero for several days and forced several Rink's stores to close briefly. This was followed by a poor holiday selling season in spite of heavy promotional markdowns taken during December and January. And the final months of the fiscal year were characterized by unprecedented layoffs at automotive plants accounting for a large proportion of employment in Rink's service area, as well as by rainy weather which held down sales of seasonal items.

While the division's 6.7 per cent sales increase was due largely to price inflation, total volume held up well under the circumstances as a result of emphasis on product lines that were



doing well and aggressive advertising and merchandising.

During the past year, Rink's relocated its soft goods warehouse operations from Cincinnati to Columbus to help provide quicker, more efficient distribution. Buying offices, formerly divided in two locations, are now entirely located at the headquarters in Toledo.

One large new store was opened at Lima, Ohio, and a smaller Michigan unit closed. No new stores are presently planned during fiscal 1976.

Rink's 39 stores are located in Ohio and adjacent areas of neighboring states, largely below a line extending from Toledo in the northwest to the southeast part of Ohio. Saturation coverage is provided in Toledo, Columbus, and Cincinnati, where about half of the Rink's stores are located, and the remainder are in smaller cities with good growth potential. The stores are large, mostly in the 80,000 to 100,000 square foot range.

Total volume of business in Rink's stores last year was $208,833,000... including $127,249,400 in direct sales by the division, $24,251,100 by leased departments operated by our Drug Division, and $57,332,500 in sales by leased departments of other companies, which provided $2,466,000 in rental revenues.

A highly experienced management team has developed a Rink's product mix suited to today's economics and consumer preferences, and through regional concepts has developed a well co-ordinated operation including close management and financial controls and efficient distribution of merchandise. It has also extended a co-ordinated and effective newspaper, TV and direct mail advertising umbrella over the entire area it serves.

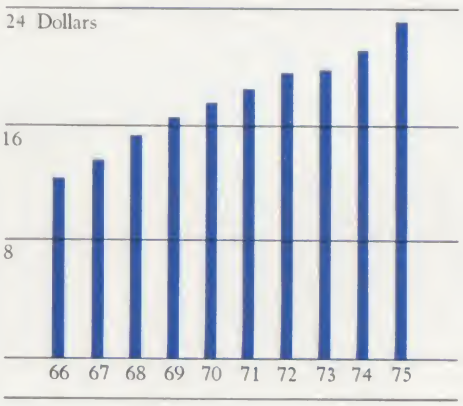
Profit margins in the discount department store business traditionally have been higher than those in chain drug store operation, and while this has not held true during today's recession, our Rink's chain is in good strategic position for profit improvement, providing the economy and consumer confidence show any pick-up in the months ahead.

Momentum Still Building

To sum up, the impact of Gray Drug's long-range programs to improve sales and profit, tighten financial controls, and strengthen our balance sheet was solidly reflected in corporate results for the past year. We believe the momentum of these programs is still building up, and that they will have an even greater effect on future operations.

"...our Rink's chain is in good strategic position for profit improvement..."

Shareholders' Equity Per Share



Consolidated Summary of Operations

	Fiscal Years Ended April 30				
	1975	1974	1973	1972	1971 (1)
Net sales	$272,063,514	$253,173,340	$226,570,253	$203,671,431	$167,218,553
Rent from leased departments	2,465,504	2,031,714	1,760,619	1,347,152	1,545,553
Cost of merchandise sold	183,760,806	172,060,042	155,445,165	136,533,482	112,026,275
Interest expense	3,232,242	2,945,774	2,168,913	1,547,570	954,247
Income taxes	3,583,000	2,927,000	1,409,000	3,557,000	3,769,000
Net income	3,923,811	3,409,144	2,092,058	3,906,249	3,814,559
Per share of Common Stock:					
Net income (2)	$2.36	$2.05	$1.26	$2.35	$2.29
Cash dividends declared	.425	.60	1.20	1.20	1.20
Average shares outstanding	1,665,040	1,665,040	1,664,457	1,662,905	1,662,540

(1) Fiscal year end changed from June 30 to April 30 effective with fiscal 1972. Fiscal 1971 figures recast to reflect change.
(2) Based on average shares of Common Stock outstanding during the year.

Other Financial Information

Income before income taxes	$ 7,506,811	$ 6,336,144	$ 3,501,058	$ 7,463,249	$ 7,583,559
Net income as a percentage of sales	1.44%	1.35%	.92%	1.92%	2.28%
Net income as a percentage of shareholders' equity	10.20%	9.67%	6.37%	11.94%	12.39%
Working capital	37,003,354	32,406,610	31,642,203	33,241,218	21,398,868
Current ratio	1.9	1.6	1.8	1.9	1.6
Property and equipment additions — net	2,614,158	3,244,439	2,858,482	3,976,697	3,719,610
Depreciation and amortization	2,152,634	2,031,043	1,806,949	1,707,502	1,406,047
Total assets	100,174,938	106,254,671	89,268,038	86,530,953	69,852,334
Long-term debt	18,200,000	16,400,000	17,200,000	18,000,000	5,800,000
Shareholders' equity	38,458,532	35,242,371	32,832,251	32,714,560	30,780,690
Book value per share	23.10	21.17	19.72	19.66	18.51

Sales and Net Income by Quarter ... Fiscal Years Ended April 30

	Sales		Net Income			
			Total		Per Share	
	1975	1974	1975	1974	1975	1974
Quarter Ended						
July 31	$ 67,453,840	$ 59,827,234	$ 478,252	$ 250,586	$ .29	$ .15
October 31	66,132,985	59,990,428	405,872	51,987	.24	.03
January 31	76,587,480	73,555,640	1,966,536	2,079,407	1.18	1.25
April 30	61,889,209	59,800,038	1,073,151	1,027,164	.65	.62
Total	$272,063,514	$253,173,340	$3,923,811	$3,409,144	$2.36	$2.05

Management's Discussion and Analysis of the Summary of Operations

Net Sales

Net sales increased 7.5 per cent in fiscal 1975 ("1975") and 11.7 per cent in fiscal 1974 ("1974"). The increased volume in both periods was attributable to the success of the drug store discount pricing program, initiated in 1971 and completed during 1972, as well as inflation. Sales also benefited from the improved performance of stores in Florida and the opening during 1974 of six discount department stores. Partially offsetting the 1975 increase were the disappointing sales from the Discount Department Store Division resulting from highly competitive pressures and the generally dismal consumer buying patterns prevalent in its industry during the last half of the fiscal year.

Rent from Leased Departments

Rent from leased departments in 1975 increased 21.4 per cent over 1974 and 1974 increased 15.4 per cent over 1973 mainly as a result of the rent generated from the lessees in the six new discount department stores opened before the Christmas season in 1974.

Cost of Merchandise Sold

Cost of merchandise sold in 1975 increased 6.8 per cent over 1974 and 1974 increased 10.7 per cent over 1973. The increases generally tended to reflect costs directly attributable to increasing sales during the periods.

Interest Expense

Interest expense for 1975 increased 9.7 per cent over 1974 and 1974 increased 25.8 per cent over 1973. The increase in 1975 reflects the higher interest rates on short-term borrowing and the increase in 1974 over 1973 relates to increased levels of borrowing along with increasing interest rates throughout the year.

Income Taxes

Income taxes for 1975 increased $700,000 over 1974 and 1974 increased $1,500,000 over 1973, resulting from increases in net earnings over the last two years. The effective tax rate for 1975 was 47.7 per cent compared to 46.2 per cent in 1974 and 40.2 per cent in 1973. The deviation between the rates and the Federal statutory rate (48 per cent) is accounted for as follows:

	1975	1974	1973
Federal statutory rate	48.0%	48.0%	48.0%
State and local income taxes net of Federal tax benefit	3.2	1.8	3.4
Investment tax credit	(2.1)	(3.3)	(9.8)
Other items	(1.4)	(.3)	(1.4)
Effective rate	47.7%	46.2%	40.2%

Net Income

Net income for 1975 increased $500,000 to $3,900,000 and 1974 increased $1,300,000 over 1973. The 1975 increase of 15.1 per cent over 1974 is attributable to the strong performance of the Drug Division resulting primarily from increased gross margins, inflation and the continuing rising volume resulting from its emphasis on discount pricing. Offsetting these gains was the disappointing drop in income during the last five months operations in the Discount Department Store Division. During December and January heavy mark-downs were taken to meet competitive prices and maintain holiday volume. Sales during the last quarter were adversely affected by the economic slowdown experienced throughout the retail department store industry. The 1974 increase of 63 per cent over 1973 was due largely to the success of the drug store discount pricing program, additional financial controls and in part to the efficiencies resulting from consolidation of all discount department stores into a single division. The decline in net income in fiscal 1973 was principally due to the effects of conversion of the Company's drug stores to discount pricing and to loss of profits in a group of department stores, the management of which was changed toward the end of the year in a reorganization of the Company's department store group.

Supplementary Income Statement Information

Maintenance and repairs for 1975 increased 38.5 per cent over 1974 while 1974 decreased 2.3 per cent from 1973. The 1975 increase is due largely to the new maintenance program initiated for the electronic cash registers installed in the Discount Department Store Division during fiscal 1972 and 1973.

Depreciation and amortization expenses increased by $224,000 in 1974 and $122,000 in 1975 reflecting an increase in the net property and equipment accounts over the last three years.

Rental expenses increased by $1,324,000 in 1974 and $879,000 in 1975 primarily due to the rental costs attributable to the nine new discount department stores opened during fiscal 1973 and 1974.

Statements of Consolidated Income and Retained Earnings

Gray Drug Stores, Inc. and Subsidiaries

	Year Ended April 30	
	1975	1974
Net sales	$272,063,514	$253,173,340
Rent from leased departments	2,465,504	2,031,714
Other income	598,762	402,279
	275,127,780	255,607,333
Costs and expenses:		
Cost of merchandise sold	183,760,806	172,060,042
Selling, general and administrative expenses	78,475,287	72,234,330
Depreciation and amortization	2,152,634	2,031,043
Interest expense	3,232,242	2,945,774
	267,620,969	249,271,189
INCOME BEFORE INCOME TAXES	7,506,811	6,336,144
Income taxes:		
Federal	3,120,000	2,707,000
State and local	463,000	220,000
	3,583,000	2,927,000
NET INCOME	3,923,811	3,409,144
Retained earnings at beginning of year	24,326,596	21,916,476
	28,250,407	25,325,620
Cash dividends paid	707,650	999,024
RETAINED EARNINGS AT END OF YEAR	$ 27,542,757	$ 24,326,596
Per share of Common Stock:		
Net income	$2.36	$2.05
Cash dividends paid	.425	.60

See notes to consolidated financial statements.

Accountants' Report

Shareholders and Board of Directors
Gray Drug Stores, Inc.
Cleveland, Ohio

We have examined the consolidated balance sheets of Gray Drug Stores, Inc. and subsidiaries as of April 30, 1975, and April 30, 1974, and the related statements of consolidated income and retained earnings and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the financial statements referred to above present fairly the consolidated financial position of Gray Drug Stores, Inc. and subsidiaries at April 30, 1975, and April 30, 1974, and the consolidated results of their operations and changes in financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Ernst & Ernst

Cleveland, Ohio
July 2, 1975

Consolidated Balance Sheets

Gray Drug Stores, Inc. and Subsidiaries

	April 30 1975	1974
Assets		
CURRENT ASSETS		
Cash	$ 3,139,261	$ 4,508,915
Accounts receivable, less allowance of $110,000 (1974 — $60,000)	3,065,027	3,122,822
Merchandise inventories	72,318,201	77,966,890
Prepaid expenses	1,997,271	1,420,283
TOTAL CURRENT ASSETS	80,519,760	87,018,910
OTHER ASSETS	196,056	238,163
PROPERTY AND EQUIPMENT		
Land ($181,462) and buildings	621,736	621,736
Furniture, fixtures and equipment	15,377,446	14,366,145
Leasehold improvements	7,928,986	7,461,816
	23,928,168	22,449,697
Less allowances for depreciation and amortization	9,556,147	8,539,200
	14,372,021	13,910,497
GOODWILL	5,087,101	5,087,101
	$100,174,938	$106,254,671
Liabilities and Shareholders' Equity		
CURRENT LIABILITIES		
Notes payable to banks	$ 9,000,000	$ 19,000,000
Trade accounts	22,063,756	25,918,555
Other liabilities and accrued expenses	3,955,280	4,000,643
Compensation and employee benefits	3,727,543	2,998,852
Income taxes	2,069,827	1,894,250
Current portion of long-term debt	2,700,000	800,000
TOTAL CURRENT LIABILITIES	43,516,406	54,612,300
LONG-TERM DEBT — less current portion — Note C	18,200,000	16,400,000
SHAREHOLDERS' EQUITY — Notes C and D		
Common Stock, par value $1 a share:		
Authorized 6,000,000 shares		
Outstanding 1,665,040 shares	1,665,040	1,665,040
Capital in excess of par value	9,250,735	9,250,735
Retained earnings	27,542,757	24,326,596
	38,458,532	35,242,371
COMMITMENTS — Note E		
	$100,174,938	$106,254,671

See notes to consolidated financial statements.

Statements of Consolidated Changes in Financial Position

Gray Drug Stores, Inc. and Subsidiaries

	Year Ended April 30	
	1975	1974
Source of Funds		
From operations:		
Net income	$ 3,923,811	$ 3,409,144
Depreciation and amortization which did not affect working capital	2,152,634	2,031,043
Total from operations	6,076,445	5,440,187
Proceeds from notes payable to banks	5,000,000	—0—
Decrease in other assets	42,107	50,361
Sale of land	—0—	317,322
	11,118,552	5,807,870
Application of Funds		
Expenditures for property and equipment, net of normal retirements	2,614,158	3,244,439
Payments and maturities on long-term debt	3,200,000	800,000
Cash dividends paid	707,650	999,024
	6,521,808	5,043,463
INCREASE IN WORKING CAPITAL	$ 4,596,744	$ 764,407
Summary of major changes in working capital:		
Asset increase (decrease):		
Cash	$(1,369,654)	$ 585,416
Accounts receivable	(57,795)	662,019
Recoverable income taxes	—0—	(708,496)
Merchandise inventories	(5,648,689)	15,388,304
Prepaid expenses	576,988	213,677
Liability (increase) decrease:		
Notes payable to banks	10,000,000	(6,500,000)
Trade accounts	3,854,799	(6,326,457)
Other liabilities and accrued expenses	45,363	(274,962)
Compensation and employee benefits	(728,691)	(380,844)
Income taxes	(175,577)	(1,894,250)
Current portion of long-term debt	(1,900,000)	—0—
INCREASE IN WORKING CAPITAL	$ 4,596,744	$ 764,407

See notes to consolidated financial statements.

Notes to Consolidated Financial Statements

Gray Drug Stores, Inc. and Subsidiaries
Years ended April 30, 1975 and April 30, 1974

Note A — Summary of Significant Accounting Policies

Consolidation:

The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. Intercompany transactions and profits have been eliminated upon consolidation.

Merchandise inventories:

Merchandise inventories are valued at the lower of cost (latest or average) or replacement market. Cost is determined on a specific item basis for inventories at the Drug Division warehouses and cost of inventories at other locations is determined by the retail method.

Property and equipment:

Property and equipment is stated on the basis of cost.

The provision for depreciation and amortization of property and equipment is computed principally by the straight-line method using rates expected to extinguish the carrying value of individual assets over their estimated useful lives.

Store preopening expenses:

Expenses related to openings of stores are expensed as incurred.

Goodwill:

Goodwill represents the excess of cost of investment in purchased companies over their recorded net assets at acquisition dates (prior to 1969) and is not being amortized because, in the opinion of management, there has been no decrease in the values attributable thereto.

Federal income taxes:

The investment tax credit on eligible leased or purchased property and equipment is accounted for by the flow-through method.

Net income per share of Common Stock:

Net income per share of Common Stock is computed using the weighted average number of shares of Common Stock outstanding each year, including, when material, the dilutive effect of the assumed exercise of stock options. The assumed exercise of stock options was not included in the computation in 1975 or 1974 since the dilutive effect in either year was less than three percent.

Note B — Short-Term Borrowings

Under informal line of credit arrangements for short-term debt with several banks (as limited by amendments to note agreements with insurance companies), the Company may borrow up to $18,000,000. Two of the arrangements provide for maintenance of average compensating balances, the amounts of which were not material in 1975. The average rate of interest on the notes payable outstanding at April 30, 1975 was 8.3%.

The maximum amount of aggregate short-term borrowings at any month end in both 1975 and 1974 was $19,000,000 (previous to application of amendments to note agreements with insurance companies). The average daily borrowings (total of daily outstanding principal balances divided by 365) during 1975 and 1974 were $10,748,000 and $14,585,000, respectively. The weighted average interest rate (actual interest expense divided by average short-term debt outstanding) during 1975 and 1974 was 11.4% and 9.1%, respectively.

Note C — Long-Term Debt

Details of long-term debt were as follows:

	April 30	
	1975	1974
Notes payable to banks:		
$8,000,000 due in quarterly installments of $200,000 through March 31, 1975, and thereafter in quarterly installments of $425,000 through March 31, 1977, interest at prime commercial rate plus ¼%	$ 3,400,000	$ 4,200,000
$5,000,000 due in quarterly installments of $250,000 through September 30, 1979, with interest at 120% of prime commercial rate	4,500,000	—0—
	7,900,000	4,200,000
Notes payable to insurance companies — $13,000,000 due in annual installments of $1,300,000 from June 1, 1977 through June 1, 1986, with interest at 9% to June 1, 1974 and 9¼% thereafter	13,000,000	13,000,000
	20,900,000	17,200,000
Less current portion	2,700,000	800,000
	$18,200,000	$16,400,000

During 1974 the Company did not comply with a covenant of the note agreements with the insurance companies which provided that current notes payable to banks (and similar indebtedness, as defined) would not exceed $2,000,000 for a continuous 45-day period during the year. Such noncompliance was waived and through amendment the amount of the 45-day current indebtedness limitation was increased to $9,000,000 in 1975, $6,000,000 in 1976, and $4,000,000 in 1977.

Loan agreements include, among other requirements, covenants regarding maintenance of working capital and limitations on current borrowings and dividend payments. Under the most restrictive of these covenants, dividends in 1976 may not exceed the lesser of $1,000,000 or fifty per cent of consolidated net income. Thereafter dividends may be increased if defined levels of net income have been attained.

Aggregate annual maturities of long-term debt for the next five fiscal years are: 1976 and 1977 — $2,700,000; 1978 and 1979 — $2,300,000; 1980 — $1,800,000.

Interest expense applicable to long-term debt was $1,985,000 and $1,599,000 for the years ended April 30, 1975 and April 30, 1974, respectively.

Note D — Shareholders' Equity

Under the Company's two stock option plans, options may be granted to officers and other key employees to purchase shares of Common Stock at not less than the market price of the shares at date of grant. The 1968 Stock Option Plan provides that qualified stock options granted thereunder become exercisable, cumulatively, to the extent of one-fourth annually beginning one year from date of grant and expire in a maximum of five years from date of grant. The 1973 Stock Option Plan provides that options granted thereunder may be either qualified or nonqualified options. Options granted under the 1973 Plan become exercisable, cumulatively, to the extent of one-fourth annually beginning one year from date of grant, and expire in a maximum of ten years from date of grant.

The following tabulation summarizes certain additional information regarding the Company's stock option plans.

	Shares	Option Price Per Share
Outstanding at May 1, 1973	41,250	$18.375 to $46.25
Granted	56,320	15.875
Canceled or expired	34,045	15.875 to 46.25
Substituted for certain expired options	23,750	18.375
Outstanding at April 30, 1974	87,275	15.875 to 23.75
Granted	73,750	6.00
Surrendered or canceled	37,940	6.00 to 23.75
Outstanding at April 30, 1975	123,085	6.00 to 18.375

During 1971, the Company granted options for 29,250 shares (of which options for 5,500 shares were subsequently canceled) at $18.375 a share, to certain optionees holding options for an equal number of shares at $46.25 a share. The lower priced options were not exercisable until the previously granted higher-priced options expired in January, 1974 and are not included in the tabulation until that date. Of the options granted during 1975, 21,775 were conditioned upon the surrender for cancelation of options previously granted at prices of $18.375 and $23.75.

At April 30, 1975 and 1974, options for 15,140 shares and 25,811 shares, respectively, were exercisable and at April 30, 1975, 24,415 shares were reserved for future grants.

Proceeds from the exercise of stock options are credited to Common Stock at par value and the excess over par value is credited to capital in excess of par value. No options were exercised in either 1975 or 1974 and there were no other changes in Common Stock and capital in excess of par value in either year.

Note E — Leases

The Company and its subsidiaries are lessees under a number of warehouse, store and equipment leases extending over various periods up to 27 years. Rental expense was:

	1975	1974
Gross rental expense:		
Noncancelable leases:		
Minimum rentals	$10,404,000	$ 9,457,000
Contingent rentals	973,000	922,000
	11,377,000	10,379,000
Cancelable leases:		
Minimum rentals	417,000	430,000
Contingent rentals	534,000	639,000
	951,000	1,069,000
	12,328,000	11,448,000
Less sublease rentals	2,466,000	2,042,000
NET RENTAL EXPENSE	$ 9,862,000	$ 9,406,000

Noncancelable leases have initial or remaining terms of more than one year, and have been considered as noncapitalized financing leases. Contingent rentals are generally based on store sales or equipment usage. Most lease contracts contain renewal options.

Future minimum rental commitments as of April 30, 1975 for noncancelable leases are as follows:

	Real Estate	Equipment	Sublease Rentals	Total
1976	$ 8,860,000	$1,046,000	$ 721,000	$ 9,185,000
1977	8,632,000	959,000	389,000	9,202,000
1978	8,255,000	913,000	350,000	8,818,000
1979	8,041,000	798,000	344,000	8,495,000
1980	7,678,000	728,000	321,000	8,085,000
1981-1985	32,785,000	1,275,000	456,000	33,604,000
1986-1990	23,551,000	—0—	—0—	23,551,000
1991-1995	14,781,000	—0—	—0—	14,781,000
Remaining years	4,852,000	—0—	—0—	4,852,000
TOTALS	$117,435,000	$5,719,000	$2,581,000	$120,573,000

The estimated present values of minimum commitments under noncancelable leases, computed using weighted average interest rates of 7.7% for 1975 and 7.5% for 1974 (resulting from interest rates ranging from 3.4% to 14.4%), were as follows as of April 30, 1975 and 1974:

	1975	1974
Real estate	$60,383,000	$58,114,000
Equipment	3,788,000	4,066,000
	64,171,000	62,180,000
Less present value of sublease rentals	1,638,000	1,428,000
TOTALS	$62,533,000	$60,752,000

If all noncancelable leases had been capitalized and the lease rights amortized on a straight-line basis and interest expense recognized based on the outstanding lease liability, net income for 1975 and 1974 would have been reduced by $537,000 and $530,000 ($.32 per share of Common Stock in both years). The amounts included in the computation for amortization of lease rights and interest expense were $4,440,000 and $4,804,000 in 1975 and $4,003,000 and $4,370,000 in 1974.

Note F — Pension Plan

The Company provides for retirement benefits for substantially all of its employees through a Company pension plan and various defined contribution union retirement plans. The Company's policy is to fund pension costs accrued. Total pension expense was $1,193,000 for 1975 and $994,000 for 1974.

Pension costs under the Company plan include normal cost and amortization of past service cost over 40 years. The market value of pension fund assets exceeded the actuarially computed value of vested benefits as of the most recent valuation date. The past service liability, as of the valuation date, exceeded fund assets at market value and accruals by approximately $1,846,000 at April 30, 1975.

The Employee Retirement Income Security Act of 1974 is not expected to have any future significant effect on pension expense, funding, or unfunded vested benefits.

Note G — Income Taxes

The differences between total income tax expense and the amount computed by applying the statutory federal income tax rate of 48% to income before income taxes were as follows:

	1975	1974
48% of pre-tax income	$3,603,000	$3,041,000
State and local income taxes net of federal tax benefit	241,000	114,000
Investment tax credit	(159,000)	(212,000)
Other items	(102,000)	(16,000)
TOTALS	$3,583,000	$2,927,000

Board of Directors

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Vice-President
Gray Drug Stores, Inc.

C. W. Evans
Retired Chairman of the Board
Gray Drug Stores, Inc.

Marvin L. Kahn
Senior Vice-President,
Drug Division
Gray Drug Stores, Inc.

Julie Kravitz*
Chairman of the Board
Pick-N-Pay Super Markets, Inc.
(Retail Food Products)

James D. McClimans*
Executive Vice-President
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Chairman and President
Curtis Noll Corporation
(Automotive Aftermarket and
Industrial Maintenance Products)

John W. Reavis*
Senior Partner
Jones, Day, Reavis & Pogue,
Attorneys

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Senior Vice-President,
Discount Department Store Division
Gray Drug Stores, Inc.

David M. Thoburn*
Senior Vice-President
The Cleveland Trust Company

Jerome A. Weinberger*
President and Chief Executive
Gray Drug Stores, Inc.

*Member of Executive Committee

Corporate & Divisional Operating Officers

Corporate Officers

Adolph Weinberger
Honorary Chairman of the Board

Jerome A. Weinberger
President and Chief Executive

James D. McClimans
Executive Vice-President

Marvin L. Kahn
Senior Vice-President,
Drug Division

Hyman R. Swolsky
Senior Vice-President,
Discount Department Store Division

Frederick W. Barney
Vice-President

Louis Berwitt
Vice-President and Secretary

Herbert H. Durr
Vice-President

Kenneth Frey
Vice-President, Finance
and Treasurer

Edward P. Habegger
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Howard I. Jones
Vice-President

Albert F. Hanzlick
Controller

Paul Grilli
Assistant Controller

Donald E. Collins
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Discount Department Store Division

Hyman R. Swolsky
Senior Vice-President

Solomon Norflus
Vice-President, Operations

A. M. Negrin
Treasurer

Fred Grant
Vice-President

Stock Listed

New York Stock Exchange
Midwest Stock Exchange

Transfer Agent and Registrar

The Cleveland Trust Company
Cleveland, Ohio

Auditors

Ernst & Ernst
Cleveland, Ohio

Counsel

Jones, Day, Reavis & Pogue
Cleveland, Ohio

Main Office

666 Euclid Avenue
Cleveland, Ohio 44114

Form 10-K Annual Report — Any shareholder, upon written request addressed to the Vice-President, Finance of the Company, may obtain a copy of the latest Form 10-K Annual Report filed by the Company with the Securities and Exchange Commission.

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216/696-2070